FREE ENTERPRISE FUND

INVEST IN ECONOMIC FREEDOM

Written Testimony of Mallory Factor
Chairman
Free Enterprise Fund
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Chairman Miller, Ranking Member Lynch, and Distinguished Members of the Regulatory Affairs Subcommittee, thank you for inviting me to testify today about my views on the critical issue of the costs and effects of the Sarbanes-Oxley Act. I would also like to thank all of you who have been working so hard to address this issue, including Reps. Patrick McHenry, Carolyn Maloney, Charles Dent, and the other members of the Government Reform Committee. I especially appreciate the attention to this issue from Reps. Sue Kelly and Tom Feeney, here today from the Financial Services Committee.

My testimony will focus on six main areas: first, the costs, both direct and indirect, that Sarbanes-Oxley has imposed on our public companies; second, the discouragement of entrepreneurship caused by Sarbanes-Oxley; third, the disproportionate affect the law has had on small businesses; fourth, Sarbanes-Oxley's negative effect on America's global competitiveness; fifth, the unintended beneficiaries of the Sarbanes-Oxley legislation; and finally, the unconstitutional board created by Sarbanes-Oxley.

My remarks are based on the extensive work that the Free Enterprise Fund and the Free Enterprise Institute, two organizations of which I am chairman, have undertaken in the past year. In addition to this work, the Institute has joined with a small Nevada accounting firm to launch a legal challenge to the constitutionality of the Public Company Accounting Oversight Board (PCAOB).

Sarbanes-Oxley has significantly increased the costs of being a public company by requiring that they comply with burdensome and overbearing regulations. The law has also forced companies that would otherwise have raised capital efficiently and economically in our public markets to opt for more-expensive private financing or to list on overseas exchanges, such as the London Stock Exchange. Whatever perceived benefits Sarbanes-Oxley provides, they come at an unaffordable price.

Sarbanes-Oxley's Costs Outweigh its Perceived Benefits

Given the statistical research, survey data, and hard empirical evidence available to us in the past few years' experience, the costs, in fact, grossly outweigh the perceived benefits.

According to an event-analysis conducted by Ivy Xiying Zhang, now a professor at the University of Minnesota, the key legislative events leading to the passage of Sarbanes-Oxley coincided with the loss of $1.4 trillion of shareholder wealth. Dr. Zhang found that no more than $400 billion could be explained by other factors; in other words, Sarbanes-Oxley had a trillion-dollar negative impact on the US economy. A one trillion-dollar loss in shareholder value--quite the opposite of the alleged restoration of investor confidence touted by the law's supporters.

The costs of being a public company have increased dramatically. The most recent survey conducted by international law firm Foley & Lardner found that since the passage of the law, the average costs of being a public company have increased by $1.8 million--a startling 174 percent increase, with the highest relative burden falling upon small business. Foley & Lardner also found that 20 percent of public companies are considering going private to avoid Sarbanes-Oxley compliance.

Compliance costs for section 404, alone, are expected to average $4.36 million per company, up 39 percent from the $3.14 million they expected to pay, according to a 2004 survey by Financial Executives International.

Estimates from the American Electronics Association show that US companies are spending an aggregate of $35 billion on section 404 compliance, far greater than SEC's projections of just $1.2 billion in June 2003.

Audit fees of *Fortune* 1000 companies, on average, increased over 100 percent from 2003 to 2004, according to a paper by professors at the University of Nebraska at Omaha.

Until the law is reformed, companies will continue to move offshore, de-list from U.S. exchanges, and go private to avoid burdensome compliance. All of these are perfectly legal strategies, of course, but they hurt the very same investors that Sarbanes-Oxley intended to protect. Moreover, companies that otherwise would have gone public in the United States and had affordable, efficient access to our capital markets are now forced to access the more expensive private or overseas capital markets.

These enormous costs cannot be what Congress intended when Sarbanes-Oxley was enacted. They must be reduced or eliminated for America to continue to grow and prosper.

Sarbanes-Oxley Discourages Entrepreneurship

It is not just established businesses that are deleteriously affected by Sarbanes-Oxley. Inaccessible public capital markets have ripple effects that touch even the earliest stage investments. With fewer liquidity events on the horizon for most start-ups, fewer early-stage investments are economical. Many of the start-ups that do get funded will have difficulty raising enough capital to succeed as they begin to grow out of their development phase. The capital that is available often takes the form of expensive private equity or mezzanine financing.

In addition, the criminal provisions in the law expand the ability of the government to wield a terrifying regulatory tool and put a further chill on entrepreneurship. Under Sarbanes-Oxley, it is now possible for CEOs and CFOs to be sent to jail for the misdeeds of others. These executives are required to certify corporate reports without traditional good-faith protections, and can be found criminally liable for honest mistakes. Uncertainty on the limits the government will put on criminal prosecution under Sarbanes-Oxley has a chilling effect on risk-taking and has sizeable opportunity costs for the U.S. economy.

Of course, nothing should get in the way of the prosecution of corrupt executives. The recent Enron trials, based on statutes that had nothing to do with Sarbanes-Oxley, show that the legal system can be effective at punishing true scoundrels. Indeed there have been more than 700 corporate crime convictions and over $250 million in restitution since 2002, all prosecuted under pre-Sarbanes-Oxley laws.

The problem with Sarbanes-Oxley is that it treats the innocent as if they were guilty—swamping everyone with a huge new cost. And most perversely of all, the costly form-filling-out required by Sarbanes-Oxley does nothing to encourage truly honest and ethical behavior. The law is mostly a series of expensive hurdles for public companies—plus a few landmines.

The Nobel Prize-winning economist Milton Friedman called Sarbanes-Oxley the biggest problem facing the U.S. economy. He said: "It's costing the country a great deal. Sarbanes-Oxley says to every entrepreneur, 'For God's sake don't innovate. Don't take chances because down will come the hatchet. We're going to knock your head off.'"

Corporate crime is serious and should be prosecuted to the fullest extent of the law. But it is important to remember that the previously existing criminal laws are being used to actually convict corporate criminals in corporate wrongdoing trials, not Sarbanes-Oxley.

Sarbanes-Oxley Disproportionately Harms Small and Medium Sized Businesses

The SEC Advisory Committee on Smaller Public Firms, the United States Small Business Administration (SBA), and countless other public and private observers have stated that Sarbanes-Oxley disproportionately affects small businesses seeking access to capital.

Michael See, of the SBA, testified before this very committee on May 3rd and spoke about the significant value of the small business sector to the US economy. He noted that small businesses create 60 to 80 percent of net new jobs in this country and file more than 13 times as many innovative patents per employee than large companies. But the fixed costs of compliance with regulations hit these innovative companies the hardest.

Last week, Foley & Lardner released their fourth annual national Sarbanes-Oxley study. The study found that there is little truth to the widely heard claims that Sarbanes-Oxley compliance costs are coming down. Rather, it showed that audit fees for small-cap companies jumped over 20 percent in 2005. From 2003 to 2005, audit fees increased a startling 141 percent for these small-cap companies, significantly higher than the still costly increases of 104 and 62 percent for medium and large capitalization companies, respectively, over that period.

For companies with less than $1 billion in yearly revenue, average Sarbanes-Oxley compliance costs have increased 174 percent overall since its inception. This law is not economical for even the largest companies, but it effectively dictates that smaller companies cannot afford to be publicly traded in the US financial markets.

The SEC's own Advisory Committee on Smaller Public Companies strongly recommended that smaller firms be exempt from the most burdensome requirements of Sarbanes-Oxley. I believe that exemptive relief for small- and medium-sized companies is the most urgent aspect of reform which Congress could address.

Sarbanes-Oxley Weakens Our Ability to Compete Globally

Companies are increasingly looking overseas where the regulatory burdens required to list in public markets are significantly lower. Recent statistics show that America's traditional leadership in financial services is at risk.

A clear trend has already emerged with respect to foreign companies, which used to list in New York regularly but are now listing elsewhere. Foreign companies do not want to be subject to the costly and onerous burdens of Sarbanes-Oxley. Thus, international companies, in many sectors of vital strategic interests such as electronics and biotechnology, are accessing the European capital markets instead of our own. For many investors who confine themselves to U.S. markets, these are lost investment opportunities. For the financial services companies here in New York as well as in other parts of our county, this is lost business—and lost jobs, less tax revenue, and a decreased international presence.

In 2000, prior to the enactment of Sarbanes-Oxley, nine of the 10 largest IPOs in the world involved the U.S. public markets. In contrast, last year nine of the 10 largest IPOs avoided the U.S. markets altogether.

Last year, the London Stock Exchange had a record year for foreign listings. In a survey of these new listings, they discovered that 90 percent of companies that considered listing in the U.S. said Sarbanes-Oxley made London more attractive. The London Stock Exchange is actually using their Sarbanes-Oxley-free status in their marketing material to attract new company listings.

In 2005, 23 of 24 firms that raised over $1 billion in capital didn't register in U.S. markets, according to the New York Stock Exchange. 129 companies listed with the London Stock Exchange last year—only six listed on the NYSE and 14 on Nasdaq.

It's axiomatic that if America loses its advantage in capital formation, then our advantage in every other index of business well-being will be put at risk, too, as the higher cost of capital caused by Sarbanes-Oxley starts to damage the rest of the US economy, including, inevitably, jobs and wages.

But do investors favor companies that are regulated by Sarbanes-Oxley? A study by Professor Kate Litvak of the University Of Texas School Of Law shows that investors, in fact, do not prefer such regulated companies. Professor Litvak compared foreign companies listed on US exchanges (and thus Sarbanes-Oxley compliant) with analogous foreign companies that were listed in foreign exchanges. These pairs of companies were matched in market capitalization, revenues, and other relevant financials, and differed only with respect to their listing and, therefore, Sarbanes-Oxley-status. She found that investors believed Sarbanes-Oxley has a net-negative effect on companies forced to comply.

This is an important point, worth pausing over: According to Professor Litvak, investors considered the costs of Sarbanes-Oxley regulation to be greater than any perceived benefits from this reform legislation.

It is clear that investors and businesses no longer wholeheartedly favor the US public markets. Global markets have shown that they can be risky and dynamic, offering investors the growth and freedom they desire.

Sarbanes-Oxley's Beneficiaries

Not everyone is negatively affected by Sarbanes-Oxley. Accounting firms, private-equity groups, and large, established companies benefit from Sarbanes-Oxley's unintended consequences. And these benefits, to these firms, are not "perceived"; they are tangible and quantifiable.

The PCAOB's requirement of full external audits of internal control measures have made the simpler, less-expensive audits offered by smaller accounting firms inadequate for public companies. Sarbanes-Oxley's rules concerning "independence" have also forced most public companies to engage not one but two of the so-called Big Four accounting firms, for audit and compliance consulting functions. Between 2003 and 2005, annual revenues at the Big Four have increased by $15 billion.

Private equity and mezzanine finance funds have also seen increases in demand resulting from Sarbanes-Oxley. When companies are shut out of the public markets, they must raise money through more costly private sources. For existing public companies, going-private transactions are seen as an escape route. These companies have turned to ever

larger pools of private capital, which are able to extract large ownership stakes for equity deals and premium interest rates on debt.

Stephen Schwarzman, CEO of the large private equity firm, The Blackstone Group, recently said Sarbanes-Oxley "is probably been the best thing that's happened to our business and one of the worst things that has happened to America. It's taken a lot of entrepreneurial zeal out of a lot of corporate managers, and as a result of that when we talk to them about going private they're really quite excited."

Very large, established companies also gain from this law. Their large revenue streams make compliance not material to their overall corporate cost structure, giving them competitive advantages. Not so for small businesses. According to a study by the American Electronics Association, companies with under $100 million in revenues spent an average of 2.55 percent of their revenues on Sarbanes-Oxley-compliance in 2004. For a small company, that extra cost can be "make or break"—the difference between sustainable profitability and unsustainable unprofitable. So Sarbanes-Oxley is not only a barrier to entry for these smaller companies, it's a barrier to survival.

The federal government effectively provided a limited number of companies and organizations with windfall profits as a result of the unintended consequences of Sarbanes-Oxley. Their self-interest has caused them to become the major proponents of this law.

Sarbanes-Oxley Created an Unconstitutional Board

The PCAOB, created by Sarbanes-Oxley, is a self-regulating organization for the auditing industry, supported by a general power of taxation over all publicly-held companies.

The PCAOB raises its own revenue through taxation of public companies, which has allowed it to support a dramatic expansion in its size and scope. This board sets its own budget and salaries; the chairman makes $615,000 a year and the other members pay themselves $500,000 a year, well in excess of the president of the United States' salary of $400,000-- and more than triple what a Member of Congress earns.

The PCAOB exercises governmental powers, therefore its members are officers of the United States who must be appointed as the Appointments Clause of the Constitution (Article II, Section II) requires: by the President, with the advice and consent of the Senate. Because Sarbanes-Oxley establishes that PCAOB members are appointed by the Securities Exchange Commission, the law violates the Appointments Clause and is unconstitutional.

The PCAOB's interpretation of section 404 of Sarbanes-Oxley requires full external audits of all internal control measures, which goes beyond the 168 words of that entire section of the law. A significant portion of the adverse economic impact of Sarbanes-

Oxley is due to this aggressive interpretation by the PCAOB, which may have been far more reasonable if tempered by the constitutionally required political oversight.

Conclusion

America's public capital markets exist at the heart of our global financial preeminence, which is, in turn, a great source of our country's prosperity and economic growth. High value-added services, particularly financial services, are the high-productivity areas in which America must excel to compete in a world where our major competitors have plentiful and affordable labor.

Sarbanes-Oxley has become a classic example of overreaction – a massive expansion of regulatory power in response to a series of extraordinary events. And yet after all the costs and burdens of that massive over-reaction are added up, America's businesses are no better governed, are less transparently operated, and their shareholders are poorer. Americans and American businesses are worse off because of this well-intentioned, but poorly realized, piece of legislation.

The common interests of businesses, investors, and all Americans would be best advanced by rethinking, reformulating, and revising Sarbanes-Oxley.

Such reform, to reduce the counterproductive costs imposed by Sarbanes-Oxley, would enable our entrepreneurs, investors, and workers to go forward into the 21st century, confident that America can continue to lead the world in competitiveness, productivity, and economic abundance.

Thank you, once again, for giving me this opportunity to present the views of the Free Enterprise Fund and the Free Enterprise Institute on this urgent national priority.